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McGraw-Hill Economics

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Business Outlook, Short-Term

After turning in a stunning performance in 1984, what can the economy do for an encore in 1985?

No way, of course, can the economy in 1985 grow as quickly as it has in 1984, when gross national product (GNP) will surge some 7% after inflation. Outside of this fairly safe assertion, however, a whole array of 1985 possibilities--from recession to continued solid growth in the 4%-5% range--deserves serious consideration.

The view here is that the economy next year will slow sharply, but not sharply enough to qualify as a recession. For 1985 as a whole, inflation-adjusted growth is forecast at 2.5%. Central to this thesis is that homebuilding will decline and auto sales will shift into neutral. Preventing a slide into recession, on the other hand, will be business capital investment along with government spending.

But what if massive government borrowing pushes interest rates up? Housing would crumble even more than anticipated; eventually capital investment could also cave in. The result: a 1985 recession. Or what if the Federal Reserve Board, convinced that inflation is under wraps, loosens monetary policy and pushes interest rates down? The result would be reviving auto and housing markets and renewed vigor in the overall economy.

In short, we're at a tricky stage in the business cycle. If you want to be pessimistic right now, focus on September's plunge in industrial

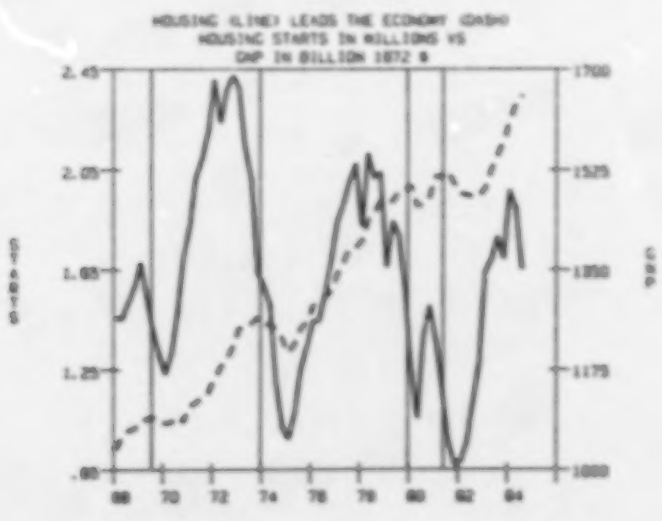
production; if it's optimism you're after, dwell on the housing and retail sales bouncebacks in September. But when it's all over, whether it's expansion or bust in 1985 will depend on the big cyclically sensitive sectors of the economy--housing, autos, and capital spending.

Housing: Is the Door Closing Shut?

Given the present stage of the business cycle--two years into a recovery/expansion--two general points about housing seem particularly salient.

One is that America's homebuilding industry typically leads the economy--both on the up and the downside. The unstartling reason is that housing is highly sensitive to interest rates. By late in a recession interest rates are usually down, so housing begins to pick up, thus spurring the economy into recovery. The opposite happens when an economic expansion turns into a downturn. Housing's leading relationship to the overall economy is depicted in Chart I. (In the chart, the vertical lines indicate business cycle peaks; preceding each peak--presaging each recession, that is--comes a decline in housing starts.)

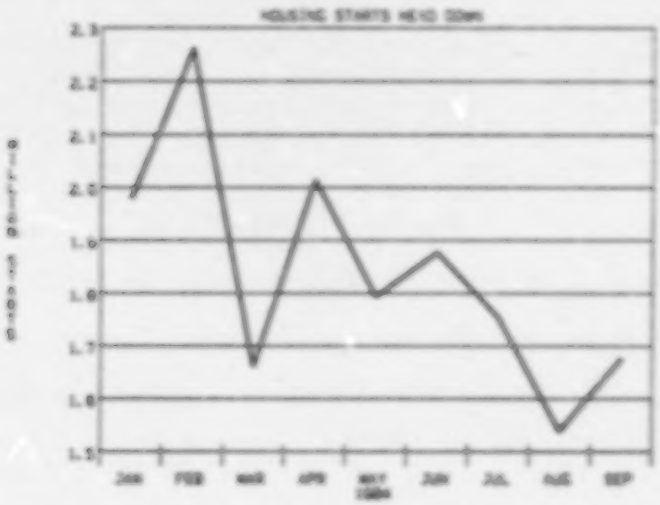
Chart I



The other key point to keep in mind right now is that housing moves in a very volatile way, as can also be seen in Chart I. So once starts start to swing, they can have an outsized impact on GNP, even though residential construction accounts for only some 3.5% of the entire economy.

Now in recent months, even with the hefty September rebound, it seems that housing starts may have begun a swing downward, as shown in Chart II. In the short run, this weakness points to reduced residential construction outlays through yearend. Looking further ahead, the fear is that this downtrend could auger something more dangerous. Back on Chart I, for

Chart II



example, look at the plunge in starts in early 1980 and during 1981.

While only nervous Nellies may wish to dwell on 1980-81, it is nonetheless disturbing to note that mortgage rates today--at about 13%--are only a little lower than in 1980. But, then again, rates are a lot lower than in 1981. What's more, relative to the cost of a house, family incomes today are higher than in the early 1980s.

The increasing affordability of housing during the economic expansion is shown in Table I, along with other housing data. The affordability index,

calculated by the National Association of Realtors, is median family income as a percent of the income required to buy a median-priced existing house. The higher the index, the greater the number of people who can afford to buy.

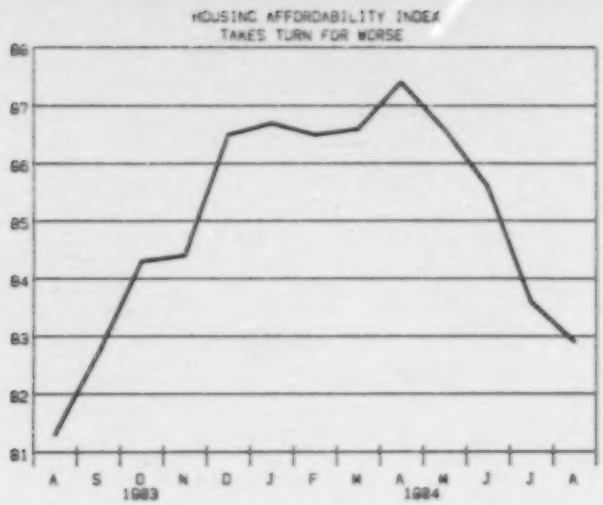
Table I. Housing Indicators Are Mixed

	Affordability Index*	Mortgage Rate (%)	Real Personal Income (% Change)	Housing Starts (Million Units)
1978	111.4	9.6	4.9	2.0
1979	97.2	10.9	2.7	1.7
1980	79.9	12.9	0.6	1.3
1981	68.9	15.0	2.7	1.1
1982	69.5	15.3	0.9	1.1
1983	83.2	12.8	3.5	1.7
present**	82.9	12.8	6.6	1.7

*See text.
**Affordability index and personal income data are for August; mortgage rate and housing starts are for September.

Because the affordability index is in decent shape compared to recent years, because mortgage rates are softening, and because peronal income is still growing, housing is not expected to collapse as it did, for example, in 1981. At the same time, because the affordability index has of late moved in the wrong direction (see Chart III), because mortgage rates remain high, and because income growth is expected to slow down, residential construction is expected to falter. . . not enough to bring down the economy like a house of cards, but enough to cause concern.

Chart III



Autos: Hitting Cruising Speed

The love affair between Americans and their autos that resumed in 1983 got yet more serious in 1984: Passenger car sales will reach an estimated 10.6 million units this year, up 15% from last year and the highest level since 1979 when sales also hit 10.6 million.

In 1985, this romance will probably continue, but it will probably not get more heated. The auto sales forecast calls for 10.7 million units, nearly the same as this year. However, if import quotas are lifted next year as scheduled, then sales of domestically produced cars are projected to dip a bit, with foreign cars making further inroads.

The problems developing in the auto market are akin to those in housing. In one word, it's affordability. In more than one word, it's high interest rates, sharply rising household debt burdens, and the expected slowdown in personal income growth.

As for high interest rates, it's true enough that fat financing charges of some 14% have not deterred millions of Americans from buying new cars. But many people had put off buying for a long time, letting their cars get older than usual. So when renewed economic growth began shoring up consumer confidence a couple of years ago, people eagerly traded in their old clunkers

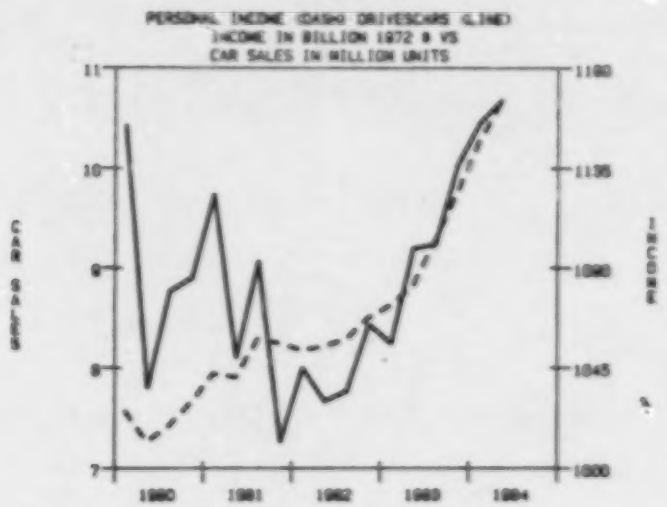
for new models.

By now, however, many who were hanging onto unwanted cars during the 1981-82 recession have replaced those cars. Hence 1985 sales will not be getting the same kind of boost from replacement that they got this year.

Giving car sales a little push on the other hand, may be a dip in auto finance rates and in gasoline prices.

The key driver of auto sales, however, is personal income, as suggested by Chart IV. And with job growth slowing as the expansion matures, income growth will slow, which will eventually apply the brakes to automobile sales.

Chart IV



Capital Investment: The Economy Depends On It

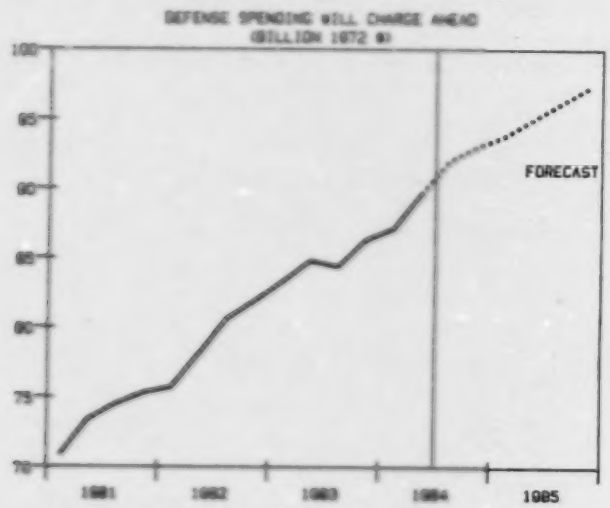
If housing does sink and autos do shift into neutral next year, as forecast, how will economic growth be sustained?

The direct answer is that most everything else will be growing. Outside of autos, other types of consumer spending should do fairly well next year. Due to the time it takes people to furnish homes once they've bought them,

appliance and furniture sales in 1985 could get a boost from the early 1984 strength in housing. Meanwhile, consumer purchases of services and nondurable goods like food and, to a certain extent, clothing tend to grow fairly steadily year by year.

In 1985, government spending will also be on the move; military spending in particular will gain ground, as shown in Chart V.

Chart V



But the key to sustained growth in 1985 will probably be business capital investment. For while government budgets for next year are in place, business capital investment is not locked in for next year; and while non-auto consumer spending usually increases relatively smoothly investment has a history of lurching erratically from one year to the next. Hence if investment takes a lurch down next year, the slow growth now expected for mid-1985 could become more severe and turn into an economic slump.

For such an investment lurch to occur, however, housing and autos and consumer spending in general would have to drag the economy down very soon. Then, after taking awhile to perceive a sustained drop in sales, firms would cut back capital budgets by, say, the spring. In this event, the economy's

cyclically sensitive sectors--those that make booms and busts--would all be pushing for a bust. In addition, firms would start trying to cut inventories, which are probably the major cyclical component in the business cycle. At this point, obviously, the economy would be in the soup.

Fortunately, though, while housing is sinking, auto sales and the rest of consumer spending are not. Hence from the perspective of capital budgeters at business firms, the sales outlook probably looks fairly promising. So right now there is no need to batten down the hatches on capital spending.

Nonetheless, a lot of budgetary caution may be getting expressed in corporate boardrooms throughout the land. For as executives study reports and charts, various unpleasantries might keep popping up, things like high interest rates (high even after recent declines), the immense government deficit, the super-strong dollar and its sidekick, a decimated trade balance.

But while these confidence-reducing conditions might lead firms to make serious contingency plans, a growing economy and good cash flow will probably prompt further gains in capital investment in 1985. Table II points out some of the strong points in the capital spending outlook.

Table II. Capital Spending Indicators Point to Further Gain

	% Increase, First Half of 1984 vs. First Half of 1983
Retail Sales	12.6%
Manufacturers Shipments	14.7
Nonfinancial Corporate Cash Flow	19.3
Construction Contracts for Nonresidential Buildings	17.0

Besides this evidence, which suggests that conditions for capital spending at the moment are not bad, a just-completed McGraw-Hill survey has found that firms plan to boost investment in plant and equipment by a little more than 4% next year, after adjusting for inflation.

While those investment intentions are hardly robust, their realization would still help boost economic growth in 1985. At the same time, given that the economy is entering the third year of a business expansion and given that investment was depressed from 1980 to 1983, these plans are not terribly optimistic. In fact, even with the tremendous capital spending boom in 1984, a "real" increase next year of only 4+% would lift the 1979-85 average annual investment growth to only 1.4%. That's half the long-run average. Nonetheless, capital spending is expected to be one of the stronger sectors of the economy next year.

Summary

After a rip-roaring expansion in 1984, the economy in 1985 is forecast to encounter some problems. Interest rates, true enough, tumbled during the fall; and that should mitigate their malignant effect. Nonetheless, rates remain high; housing has been reacting and will probably continue to react.

Consumers looking at new cars may also react. At the least, the large replacement demand for autos built up during the 1981-82 recession has probably abated. Hence there is less room for an auto sales surge than there was in the past couple of years.

Other types of consumer spending will probably keep chugging along at a modest pace, and government spending should be strong in 1985. So the economy

is not forecast to fall into a housing/auto-driven recession. In addition, after a boom in 1984, capital spending still has some life left in it. But based on the recent McGraw-Hill survey, that life is not vigorous.

In 1984, almost all economic sectors pulled for growth, with foreign trade the big exception. But in 1985, some of those sectors will slip. As a result, economic growth is expected to slip from nearly 7% in 1984 to 2.5% in 1985.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1984		1985				1986	Years		
	III	IV	I	II	III	IV	I	83	84	85
National Product Accounts										
Gross National Product.....	3,701	3,757	3,826	3,871	3,912	3,973	4,042	3,305	3,664	3,895
Consumer Spending.....	2,359	2,410	2,451	2,486	2,518	2,555	2,599	2,156	2,345	2,502
Durables.....	317	328	333	335	336	340	346	280	319	336
Nondurables.....	863	879	889	898	907	917	930	802	860	903
Services.....	1,179	1,204	1,230	1,253	1,275	1,298	1,323	1,074	1,165	1,264
Nonresidential Fixed Investment.	432	438	447	456	463	470	480	353	422	459
Structures.....	152	153	157	160	163	166	170	130	149	162
Equipment.....	280	285	290	295	300	304	310	223	273	297
Inventory Change.....	72	56	54	43	29	30	30	-13	63	39
Residential Investment.....	153	149	150	150	152	155	159	129	150	152
Federal Government.....	308	313	322	328	334	342	348	270	296	331
Defense.....	225	232	238	243	248	256	262	201	223	246
Nondefense.....	82	82	84	85	86	86	86	69	73	85
State & Local Government.....	459	468	477	487	496	505	514	416	453	491
Net Exports.....	-86	-81	-79	-82	-85	-88	-92	-8	-69	-84
Real GNP (1972 Dollars).....	1,650	1,659	1,672	1,677	1,681	1,690	1,702	1,535	1,640	1,680
(% change, annual rate).....	2.7	2.3	3.1	1.3	0.9	2.1	2.8	3.7	6.8	2.5
Implicit Price Deflator.....	2.244	2.264	2.288	2.308	2.327	2.351	2.376	2.153	2.234	2.319
(% change, annual rate).....	3.6	3.7	4.3	3.5	3.4	4.2	4.2	3.8	3.8	3.8
Key Economic Indicators										
Housing Starts (million units)...	1.656	1.665	1.692	1.679	1.652	1.698	1.776	1.704	1.796	1.680
Retail Auto Sales (million units)	10.3	11.0	10.9	10.8	10.6	10.5	10.5	9.2	10.6	10.7
Industrial Production (Index, 1967=100).....	165.7	166.4	167.5	168.3	168.2	168.7	169.9	147.6	163.7	168.2
Civilian Unemployment Rate.....	7.5	7.3	7.3	7.4	7.5	7.7	7.7	9.6	7.5	7.5
Consumer Price Index (% Change, Annual Rate).....	3.6	3.9	3.7	3.6	3.5	4.0	4.4	3.2	4.2	3.7
Personal Income (billion $).....	3,048	3,098	3,153	3,193	3,232	3,285	3,343	2,744	3,013	3,216
3-Month Treasury Bill Rate (%)...	10.3	9.7	9.6	9.3	8.9	8.9	8.8	8.6	9.8	9.2
Corporate Bond Yield (%).....	13.0	12.4	12.3	12.1	11.9	11.7	11.6	12.0	12.7	12.0
Personal Income ($ Billions, SAAR).....	3,048	3,098	3,153	3,193	3,232	3,285	3,343	2,744	3,013	3,216

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Business Outlook, Short-Term

Back during the summer, with high interest rates hitting housing and subverting consumer confidence, it looked like the economy was headed for a few quarters of very sluggish growth. In fact, in 1984's third quarter, the economy grew barely at all.

But that summer vacation seems to have been just the tonic needed to restore vitality: The short economic slump brought interest rates thudding down, setting the stage for future gains in consumer durable spending, housing, and capital investment. It looks like the Reagan economy will therefore continue to roll through 1985—not at 1984's breakneck speed of 6.8%, but at a respectable trot of 3%-3.5%.

To be sure, huge budget and trade deficits remain part of the outlook. But for the time being, it seems that fears over the potentially crippling effects of these deficits should probably be focused more on 1986 and beyond, because 1985 looks OK.

The Welcome Slide in Interest Rates

Out of weakness, strength. That might be the economy's motto right now. For it was economic weakness in 1984's third quarter that took the pressure off interest rates and allowed them to tumble. And it is this slide in interest rates that should allow the economy to recoup and continue growing at a decent pace (3% or so per quarter) through 1985.

Chart 1 shows the prime rate along with the percent change in commercial and industrial loans at large commercial banks. Note that when the economy was red hot in the first half of 1984, loan demand surged. Then as business activity tapered off, growth in loan demand tapered off too; and shortly thereafter, the prime rate was cut. Meanwhile, as usual, lots of people were trying to guess what the Federal Reserve Board was up to. Also, as usual, people were disagreeing about what the Federal Reserve Board was up to.

Chart I

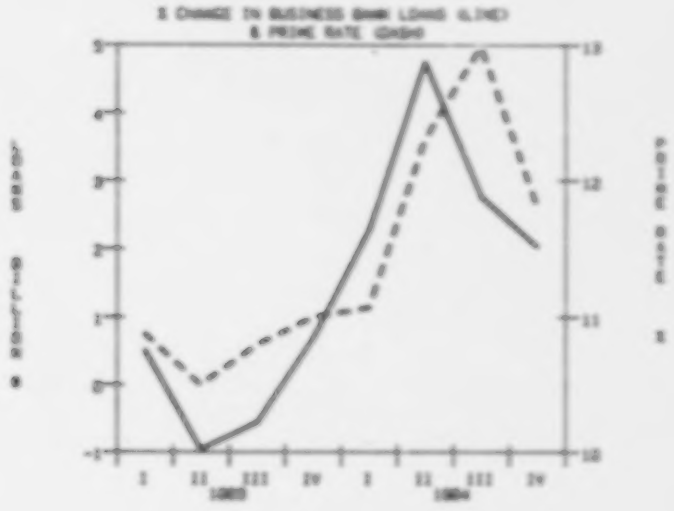


Table 1 provides a statistical summary of what the Fed did during the period; not surprisingly, the evidence is contradictory. At a minimum, however, given that interest rates did fall, it seems safe to assert that the Fed did not prevent that fall. And the assumption in the forecast is that the Fed will not tighten credit and try to push rates back up. With inflation under wraps, moreover, investors' inflationary expectations may finally be declining, which means rates could come down further.

After the slow-growth scare of the third quarter, however, more important than what the Fed had in mind is what the economy's reaction to falling interest rates will be in the coming year.

Table 1. The Fed is Both Stingy and Generous

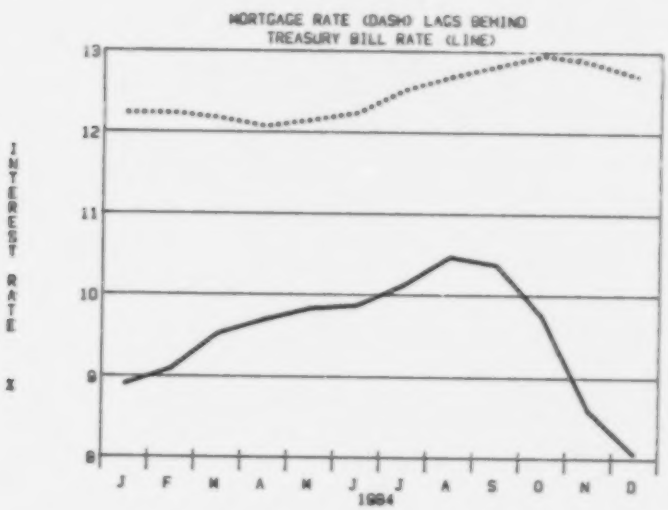
	1984 I	1984 II	1984 III	1984 IV	Average 1970-79	Average 1979-84	Characterization of Monetary Policy III(Q)	Characterization of Monetary Policy IV(Q)
Money Growth (% Change, SAAR)								
M1	7.4	6.3	4.6	1.9	6.7	7.5	tightening	tightening
M2	7.1	7.0	6.4	9.7	10.2	9.5	tightening	easing
Monetary Base	8.7	9.3	6.5	5.0	8.1	7.8	tightening	tightening
Nonborrowed Reserves % Change, SAAR	8.3	-3.7	19.2	0.6	4.6	6.5	easing	tightening
Free Reserves Billion $	0.02	-1.25	-0.25	-0.06	-.683	-.551	easing	easing
Federal Funds Rate(%) end of quarter	10.0	11.3	10.7	8.4	7.1	10.2	easing	easing

SAAR--Seasonally adjusted annual rate

New Interest In Economic Growth

The ability of the economy to bounce back from adversity showed up in the final quarter of 1984, when activity grew at a 3.9% annual rate. It's true that some of the fourth-quarter growth may have been "stolen" from the previous quarter because of the September auto strike, meaning that growth at the end of the year may have been overstated. But outside of autos, other kinds of consumer spending also picked up in the October-December period. It may be that falling interest rates shored up the confidence of consumers worried about heavy debt burdens. If so, that augers well for the first few months of 1985 at least.

CHART II



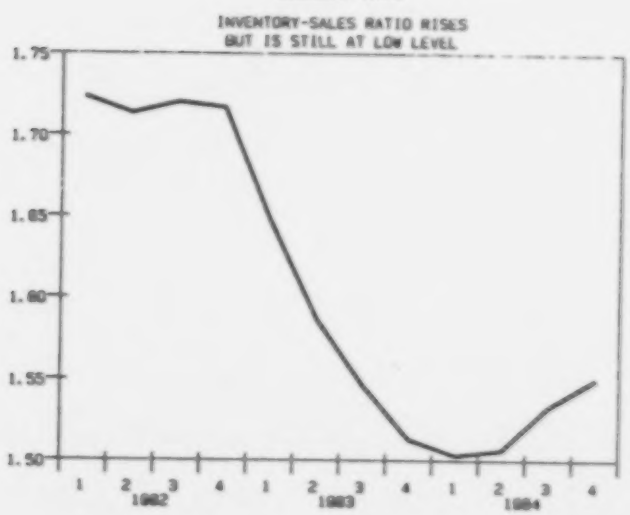
Nonetheless, the interest rate drop had yet to boost housing by yearend 1984. (Housing starts fell 23% at an annual rate in the October-December period.) One reason: Mortgage rate declines tend to lag behind other rates, as illustrated in Chart 2. Another possibility: prospective house buyers may have been waiting for rates to drop still further. By early 1985, however, lower mortgage rates should push new house construction back into the plus column as a contributor to economic growth.

Lower interest rates should also make it less financially urgent for companies to chop inventories. And the less chance there is that companies whack inventories, the less chance there is the economy will take a sudden swing down. For inventory cuts translate into reduced orders for manufactured goods, then reduced output, and reduced employment and consumer purchases.

In 1984's fourth quarter, smaller inventory accumulation than in the third quarter took away from economic growth. This decline in the rate of inventory building stemmed from the slow sales pace of the third quarter that left many firms with stocks too high relative to sales. Since this inventory correction has already occurred, it reduces the threat of another correction cutting economic growth in the early part of 1985.

As shown in Chart 3, business inventories relative to sales did climb in the fourth quarter, despite the slowdown in inventory accumulation. Nonetheless, the ratio remains low, suggesting that stock building will continue.

CHART III



Another big sector of the economy usually regarded as interest rate-sensitive is capital spending. To the extent that business investment in plant and equipment depends on interest rates, then, capital investment will also benefit in early 1985. But business capital spending is a lot more dependent on the state of demand in the economy than on the state of interest rates. As just discussed, though, the state of demand is in part driven by interest rates. So with lower rates pointing to solid consumer spending, solid inventory investment, and a pickup in housing, the engines are in place to power further gains in capital spending. The latest McGraw-Hill investment survey, for example, found that U.S. business plans to raise capital outlays moderately in 1985, after lifting investment by boom proportions in 1984.

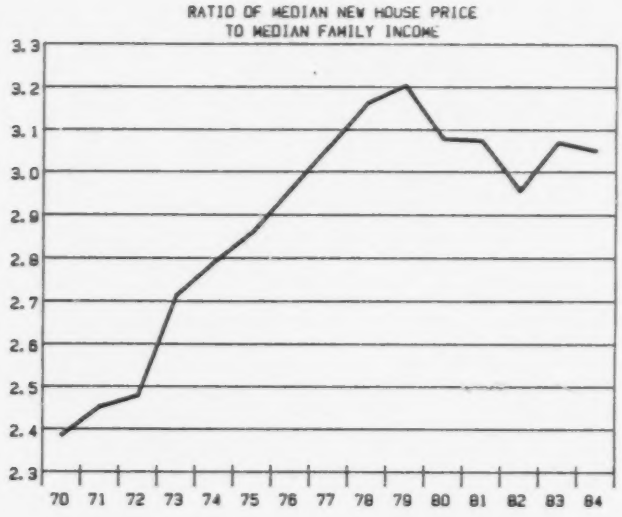
Housing: The Chink in the Armor?

What has some forecasters especially effulgent about the economy of late is the prospect of a renewed surge in new home construction. For a few months early in 1984, housing starts hit a seasonally adjusted annual rate of two million—an excellent level of activity, perhaps an astonishing level given conventional mortgage rates of 12+%. But as 1984 wore on, the housing luster wore off: By the end of last year starts had plunged 25% from earlier peaks.

Prime reason for the housing decline was probably the rise in conventional mortgage rates (see Chart 2). At the same time, mortgage lenders started to back off from the highly attractive "teaser" rates on their adjustable rate mortgages (ARMs). Perhaps, too, homebuyers had gotten a bit wary of ARMs since mortgage rates had risen on average in the past couple of years. Whatever the reason, the ARM-financed portion of mortgage loans made in December dropped to 50%, down from 68% in August, and marking the lowest share since October 1983.

So, with rising mortgage rates came declining housing starts. But during the autumn short-term interest rates tumbled, sparking hopes for a reinvigorated housing industry. And the forecast does call for a solid bounceback, the crucial assumption being a percentage point drop in mortgage rates between now and the end of 1985. Another essential is continued growth in personal income; in 1984, strong income growth made housing more affordable for millions of American families because it more than offset a rise in house prices. Since 1979, in fact, median family income on average has advanced more rapidly than new single-family house prices, as shown in Chart 4. That's the good news.

CHART IV



There are two pieces of bad news. One is that house prices are still far higher than income compared to the early 1970s, a strong era for house construction. The other piece of bad news is that higher mortgage rates have more than offset the relative rise in incomes in the past half dozen years, thus reducing housing affordability. Table 2 illustrates this second point.

Table 2, 1984 Family Income Distribution

Income	Number of Families (Millions)	% of All Families
under $24,000	28.48	45.5
$24,000-$26,750	3.32	5.3
$26,750-$29,425	3.57	5.7
$29,425-$32,100	2.94	4.7
$32,100-$53,500	16.34	26.1
$53,500+	7.89	12.6
TOTAL	62.60	

	1984				-1978-
Median Price of House	$80,000	$80,000	$80,000	$80,000	$56,000
Median Mortgage (25%)	60,000	60,000	60,000	60,000	42,000
Average Mortgage Rate	13	12	11	10	9.6
Annual Mortgage Payment	7,800	7,200	6,600	6,000	4,032
Income Needed to Qualify for Mortgage (3.5 x Payment (4 x for 1978)	31,200	28,800	26,400	24,000	16,128
Approximate Number of Families Qualifying (Mil.)	25.2	28.0	31.1	34.1	32.5
Families Qualifying as % of All Families	40%	45%	50%	54%	56%

NOTE: 1984 income figures estimated from 1983 data in "Current Population Reports, Consumer Income, Series P-60, No. 145," published by the U.S. Census Bureau.

The top portion of the table shows estimated family incomes in 84. (Families exlude single people and unrelated individuals living in the same household.) The bottom portion works out the income needed to qualify for a mortgage on a median-priced house, given different mortgage rates. (The current conventional rate is a little above 12%, with the ARM rate about a point lower.) The table then provides an estimate of how many families have enough income to qualify. A down payment of 25% and an income 3.5 times the mortgage payment are assumed. Next to the various scenarios for 1984 are similar figures for 1978, using that year's average mortgage rate of 9.6%, but assuming stricter loan standards requiring that income be four times the mortgage payment.

The conclusion is that even with a larger population and looser loan standards in 1984, fewer families today can afford a median single-family house than in 1978. Even if mortgage rates do fall another percentage point, fewer families than in 1978 might qualify if ARMs continue to decline in popularity.

The implication is that high interest rates remain a severe drag on housing; and while declining rates would obviously help, the drop would have to be hefty indeed to boost single-family starts back to the heights (1.4 million) of 1978. Conversely, though, if fewer people can afford houses, more may demand apartments, pushing up the share of multi-unit housing starts. Which is what's happened in the past few years: In 1978, multi-units comprised 29% of the total two million starts. In the housing revival years of 1983-84, multi-units reached 38% of the total, flying in the face of demographic forecasts made not many years earlier.

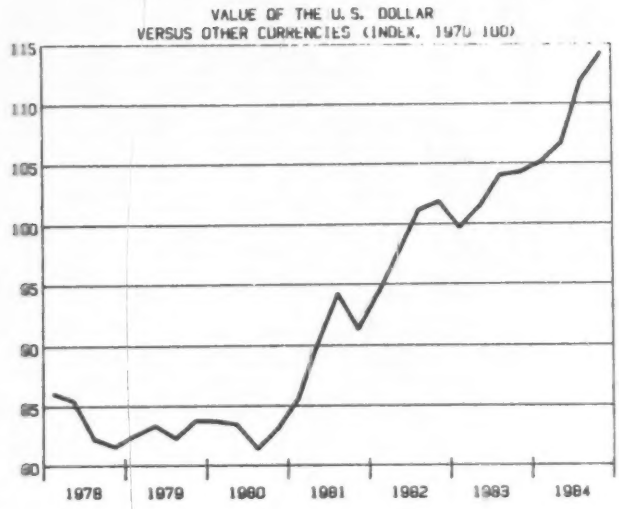
Those forecasts, focusing on the huge number of baby boomers entering the prime house-buying age groups, promised an explosion in single-family construction. But the potential surge in demographic demand got shut down by mountainous mortgage rates. While the mountain may get a little easier to climb as 1985 progresses, many people will still have to struggle. Hence for the year as whole, housing will make few if any gains over 1984. And apartments will likely maintain their share of total residential construction.

The Duo-Deficit Dilemma

While declining interest rates have brightened the outlook for consumer spending, inventory investment, housing, and capital spending, hope for a weaker dollar--hence a stronger trade balance--remains dim. Chart 5 points out the continued strength of the dollar in the past half year when U.S.

interest rates fell, as well as the currency's stupendous surge in the past four years.

CHART V



To use an ice hockey analogy, it's as if the dollar is constantly running a power play because other currencies are constantly running afoul of something. For the British pound, it's declining crude oil prices; for the French franc, it's suspect domestic economic policies; for the German mark, it's political difficulties and strikes. On the upside for the U.S. dollar, the key advantage appears to be economic growth--hence investment opportunities--plus that great intangible, confidence.

Even declining interest rates--i.e., lower returns for foreign investors--have not dulled the world's appetite for the buck. Nor has the mammoth and expanding U.S. trade deficit scared investors away. As soon as foreigners receive payment in their own currencies for exports to the U.S., they apparently go right out to by dollars to invest in the U.S.--literally, that is, the bucks stop here.

The other mammoth deficit that worries some Americans is the federal government's. Pooh-poohers argue that interest rates have declined in recent

years even though budget deficits have mushroomed; but this argument seems more political than economic.

Interest rates are too complex to have a single cause such as the deficit. It's true that even though the deficit ballooned in 1982, interest rates plunged. But why? Because 1982 was a year of deep recession, hence weak loan demand. And at the same time, the Fed also expanded the money supply at a rapid rate.

In 1983, the deficit grew again; and during the year interest rates rose a bit, but they never rose to anywhere near the peaks of 1981-82. Why not? The inflation rate in 1983 was far lower than in 1981-82. The result: real borrowing costs--the difference between market interest rates and inflation--did rise in 1983 to slightly above the real 1982 level and far above the real level in 1981. In 1984, real borrowing costs rose again, despite a small dip in the deficit.

Arguing that deficits don't matter may be a plank in an argument against tax hikes. But taxes are in part a political issue, revolving around the allocation of resources between the public and private sectors. On the other hand, the strictly economic impact of big deficits, no matter how created, seems clear--interest rates remain excessively high, especially compared to inflation. And if you think interest rates aren't too high, ask construction people why homebuilding lags behind the levels of several years ago when the population was smaller; and ask U.S. manufacturers how the dollar has affected their business.

In 1985, both the trade and budget deficits will remain big; and they could get bigger. The Reagan Administration, in fact, projects that the budget deficit will grow in 1985. Thus while other sectors of the economy appear in pretty good shape, these dual deficits lurk in the background, and could conceivably come forth to do some damage before the year is out.

Summary

A few months ago, economists feared we were slipping into several quarters of very sluggish growth. Sluggishness did, in fact, hit; but it hit hard enough to drive interest rates down, which in turn shored up the economy. In restrospect, the short but rapid slowdown in economic growth may be viewed as something of a surgical operation that makes the patient uncomfortable for awhile, but for the sake of avoiding more serious discomfiture later on. If that is the case, all is well and good...at least for 1985, with the economy growing at a 3+% rate on the strength of consumer, business, and government spending.

There are, however, possible junctures at which growth could get derailed. If President Reagan's plans for cutting the deficit founder badly, financial markets could send interest rates higher. The most vulnerable victim of such a move would be housing, which the forecast assumes will be improving in 1985.

If the dollar continues up, the already super-red trade balance will turn yet a shade deeper. Those industries most affected--by and large all manufacturing industries, including high-tech--could respond by cutting employment, which would then ripple through the rest of the economy.

In 1984, however, despite huge budget and trade deficits, the economy turned in a stunning performance. The 1985 encore can't be a impressive. But it should still rate respectful applause.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1984	1985				1986		Years		
	IV	I	II	III	IV	I	II	83	84	85
National Product Accounts										
Gross National Product.....	3,753	3,816	3,878	3,934	3,993	4,052	4,116	3,305	3,661	3,905
Consumer Spending.....	2,399	2,444	2,482	2,520	2,559	2,601	2,646	2,156	2,342	2,501
Durables.....	325	333	339	345	350	356	362	280	318	342
Nondurables.....	872	883	892	901	911	923	936	802	858	897
Services.....	1,202	1,228	1,251	1,274	1,298	1,322	1,348	1,074	1,166	1,263
Nonresidential Fixed Investment.	449	455	461	467	475	483	494	353	426	465
Structures.....	158	159	161	163	164	167	170	130	150	162
Equipment.....	291	296	300	305	310	316	324	223	276	303
Inventory Change.....	31	29	31	31	34	33	31	-13	57	31
Residential Investment.....	151	151	155	163	167	170	171	129	150	159
Federal Government.....	316	325	331	336	344	349	354	270	296	334
Defense.....	231	239	243	248	255	261	267	201	221	246
Nondefense.....	85	86	87	88	89	88	88	69	74	88
State & Local Government.....	467	476	485	493	502	510	518	416	452	489
Net Exports.....	-64	-67	-70	-81	-92	-99	-104	-8	-66	-77
Real GNP (1972 Dollars).....	1,661	1,674	1,688	1,700	1,711	1,721	1,732	1,535	1,639	1,693
(% change, annual rate).....	3.9	3.2	3.3	3.0	2.6	2.3	2.6	3.7	6.8	3.3
Implicit Price Deflator.....	2.259	2.280	2.298	2.314	2.333	2.355	2.376	2.153	2.234	2.306
(% change, annual rate).....	2.4	3.7	3.2	2.8	3.4	3.7	3.7	3.8	3.7	3.2
Key Economic Indicators										
Housing Starts (million units)...	1.559	1.686	1.809	1.893	1.901	1.873	1.817	1.704	1.771	1.822
Retail Auto Sales (million units)	10.2	10.8	10.6	10.8	10.7	10.7	10.7	9.2	10.4	10.7
Industrial Production (Index, 1967=100).....	165.3	167.3	168.2	169.0	169.9	171.0	172.2	147.6	163.4	168.6
Civilian Unemployment Rate.....	7.2	7.2	7.2	7.2	7.2	7.3	7.3	9.6	7.5	7.2
Consumer Price Index (% Change, Annual Rate).....	3.9	3.5	3.2	3.2	3.7	4.1	4.2	3.2	4.2	3.5
Personal Income (billion $).....	3,100	3,147	3,183	3,224	3,273	3,323	3,382	2,744	3,013	3,207
3-Month Treasury Bill Rate (%)...	8.8	7.5	7.3	7.5	7.9	8.3	8.5	8.6	9.5	7.5
Corporate Bond Yield (%).....	12.3	11.9	11.5	11.3	11.2	11.3	11.3	12.0	12.7	11.5
Personal Income ($ Billions, SAAR).....	3,100	3,147	3,183	3,224	3,273	3,323	3,382	2,744	3,013	3,207

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Business Outlook, Short-term

It's nail-biting time again for the economy. With first-quarter growth at a meager 1.3% annual rate, does it mean the economy is in the soup? Or can the first-quarter data be discounted as flukey?

Considering that a big contributor to first-quarter weakness was a surge in imports, it's unlikely that another similar surge will occur in 1985's second quarter--so the trade deficit will not be hurting growth this spring as it did in the winter.

Then there's the flap over the IRS computer problems that have delayed payments of tax refunds. This snafu probably crimped consumer spending a bit in the first quarter. Residential construction also fell; but more recently, housing starts have risen sharply, pointing to construction gains in the spring.

In short, it looks like economic growth will bounce back by 1985's second quarter. But good near-term prospects notwithstanding, the economy does face serious problems--with foreign trade at the top of the list. Even if not repeated on the same scale as in the first quarter, the continuing import inundation does contain an ominous implication for the U.S. economy. For it makes the economy vulnerable to a downturn if any other key sector takes an unexpected dip.

The Good News Driven Out by the Bad

When the economy is boiled down to a single number--gross national product (GNP) growth--there's always a chance that a lot will get hidden. The single number for the winter quarter was 1.3%, and a very low and disappointing number it was. If all the major components of GNP had edged up only 1.3%, disappointment would have bordered on despair, for it would have suggested no strength anywhere in the economy.

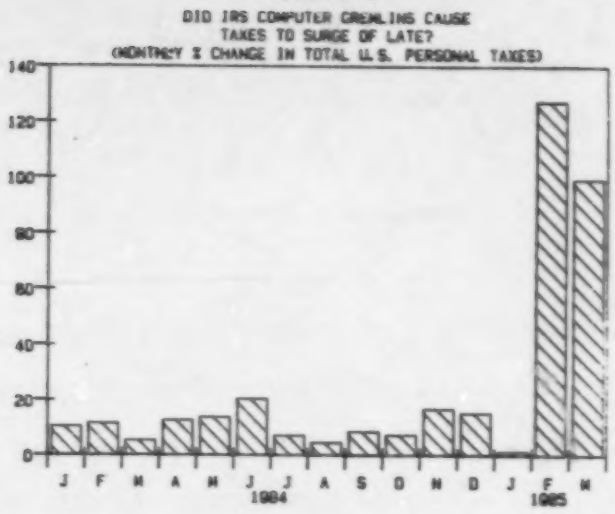
But such was not the case. Most important, consumer spending rose at a very healthy 4.7% annual rate, after adjusting for inflation. Since consumer spending accounts for nearly two-thirds of GNP, a healthy gain in this sector insures that the economy cannot be falling apart. Also significant in the first quarter--business capital investment rose at a 3.4% annualized rate.

On the other side of the ledger, residential construction and government spending each slipped about 1%. The big negative, though, was foreign trade--at an annual rate, real exports sank 8% while imports rocketed 26%. In other words, lots of the products that consumers and businesses bought came from abroad. In fact, if trade were ignored, the economy would have grown at a spiffy 4.4%, or by three percentage points more than it actually did.

The conclusion: American buying power remains intact; what is not intact is American producers' ability to compete in world markets dominated by a powerful dollar.

The U.S. trade dilemma is fundamental to the future of the economy. Less momentous is the IRS computer glitch that may have depressed personal disposable income, hence consumer spending. Outside of IRS statements about delays in processing tax refunds, some statistical evidence has also appeared: Real personal income increased at a 2.8% annual rate in the January-March period, but disposable income fell. Usually, these two measures move together. Perhaps they weren't in sync in the first quarter because,

CHART 1



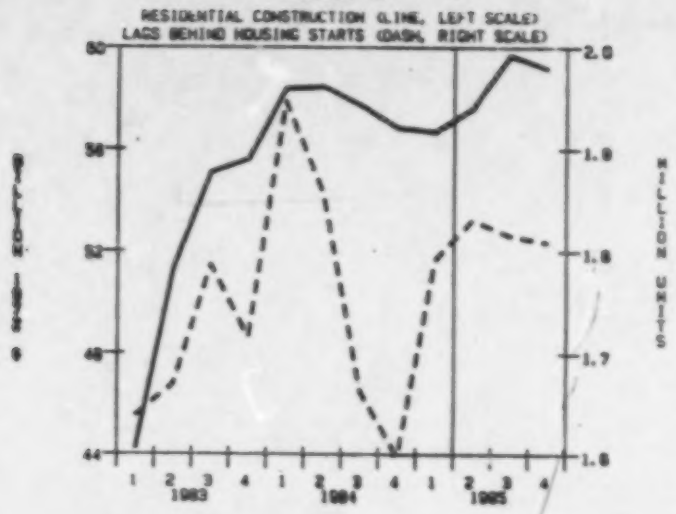
seasonally adjusted, tax payments were overblown, thereby reducing disposable income and consumer spending. (See Chart 1.)

The implication: With refunds getting paid out now, disposable income in the second quarter will get a boost that will in turn help out consumer spending and business confidence.

Government and Housing Should Rebound

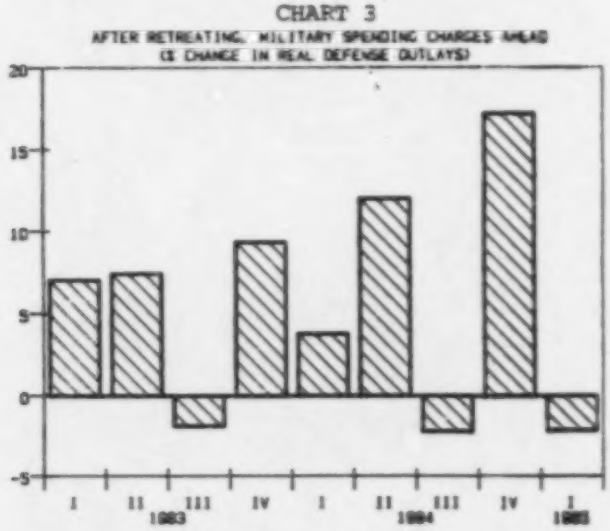
The evidence on housing and government spending also suggest a positive turnaround in the second-quarter GNP number. Residential construction lags a bit behind housing starts because once ground is broken it can take a few months to complete a house, longer in the case of an apartment building. Housing starts crumbled in the final quarter of last year, leading to weakness in construction in this year's first quarter. But more recently, softening mortgage rates helped stimulate a rise in starts, which should contribute to economic growth this spring, as illustrated in Chart 2.

CHART 2



Government spending dipped early this year because military outlays declined. Surely, however, the military budget is bursting with projects; it's just that the Pentagon hasn't spent as fast as Congress has allocated. Presumably outlays will catch up, as they have in the past couple of years whenever they malingered for a quarter. (See Chart 3.)

CHART 3



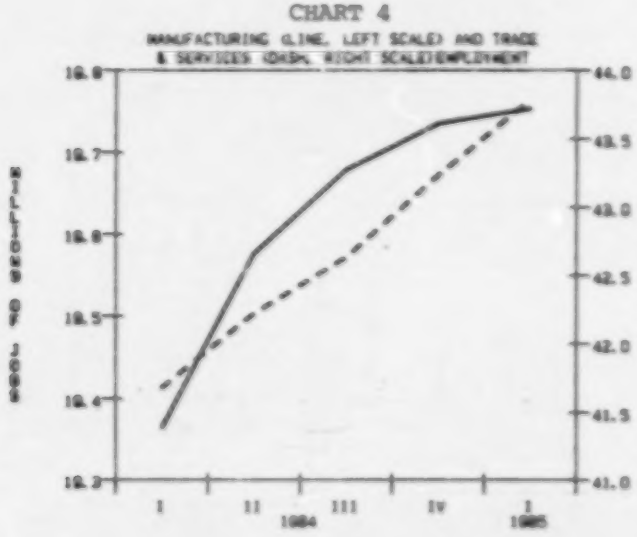
So again, it looks like first-quarter developments point to an improved second quarter. To put it another way, the single GNP growth figure seems to exaggerate the negative news of this past winter, which could lead to undue pessimism among business people and government policy makers.

The forecast, in contrast, calls for growth of 3% for the full year 1985, with consumer spending, business capital investment, and government spending the major props.

Consumer and Business Spending on Track

Consumer spending should continue buoyant this year because employment has been strong, which presages decent gains in purchasing power. In 1984, the U.S. economy created some four million new jobs. In the first quarter of 1985, six hundred thousand additional jobs were generated. Granted, many of these jobs--about two million--came in trade and services, which are mostly low-paying. But manufacturing employment last year also grew substantially. (See Chart 4.)

CHART 4

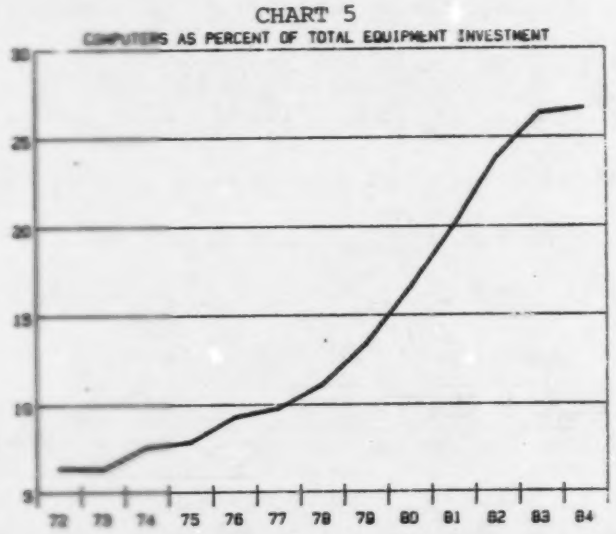


Now that the economic expansion has reached a mature stage, and given that many U.S. manufacturers are getting clobbered by imports, manufacturing employment may stop growing. But manufacturing wages are growing, and employment prospects in nonmanufacturing remain fairly good, so momentum to keep up consumer spending seems intact.

Momentum for continued business spending on new plant and equipment also seems intact. Yet despite an overall gain in the first quarter, the winter data did include a show-stopper--investment in producer's durable equipment declined because business outlays for computers plummeted.

This result dovetails with the weak first-quarter sales and earnings reports from individual computer companies. If this "trend" persists, the previously confident view of 1985 capital spending would have to be discarded, because computer purchases have become a major part of business investment. As Chart 5 illustrates, when measured in constant 1972 dollars, computers and other office equipment have surged to more than a quarter of total investment in producers durable equipment.

CHART 5



Judging from history, it seems improbable that computer investment will just fall off a cliff and lie crippled in a gulley. Many companies may understandably be trying to master their current office technology before

plunging into a new round of upgrading. But the basic impetus to cut costs on all fronts, on both office and shop floor, is obviously still there--as underscored by the import onslaught of the first quarter. Business computer sales, therefore, should still be programmed for a rebound, which will push up overall equipment investment.

In contrast to computers, investment in industrial machinery spurted in the first quarter; further gains are forecast as manufacturers struggle against imports by modernizing their production processes.

For the same reason, modernization of industrial structures is also forecast to grow smartly this year, despite manufacturing operating rates that are by no means robust. In fact, because modest operating rates imply higher-than-optimal operating costs, manufacturers are expected to respond by spending on new, more efficient plant and equipment.

In the first quarter, however, while factory construction did increase, the powerhouse in nonresidential building was in the commercial sector. Specifically, real outlays on construction of stores and other nonoffice structures surged at a 46% annual rate, continuing the torrid performance of 1984. Office construction also continued strong.

But offices go up in defiance of economic logic--namely, that very high and still-rising vacancy rates should bring the wave of office building down with a crash. The main rationale for continued strength in offices probably lies in the U.S. tax code, which though facing change still seems to be stimulating real estate deals. If offices succumb to the realities of excessive space, overall nonresidential construction could weaken substantially later this year.

Trade Holds the Economy Hostage

The sections above may be summarized as follows: The economy early this year looked shaky, but important sectors are still reasonably healthy--consumer spending, business capital investment, housing, and government spending.

Missing from the list, of course, is net exports, whose trail of red ink is plotted in Chart 6. As noted earlier, the U.S. economy exclusive of foreign trade grew briskly in the January-March period.

Declines in the dollar in March and April may have aroused hopes of a turnaround in trade. But note in Chart 7 that the buck remains way above its exchange value in 1984, the first year in post-World War II history that real U.S. net exports came in on the debit side of the national income ledger. To point up the rapidity of that plunge, consider that exports minus imports measured in 1972 dollars went from plus $48.8 billion (annual rate) in the first quarter of 1981 to negative $26.1 billion in the first quarter of 1985.

CHART 6

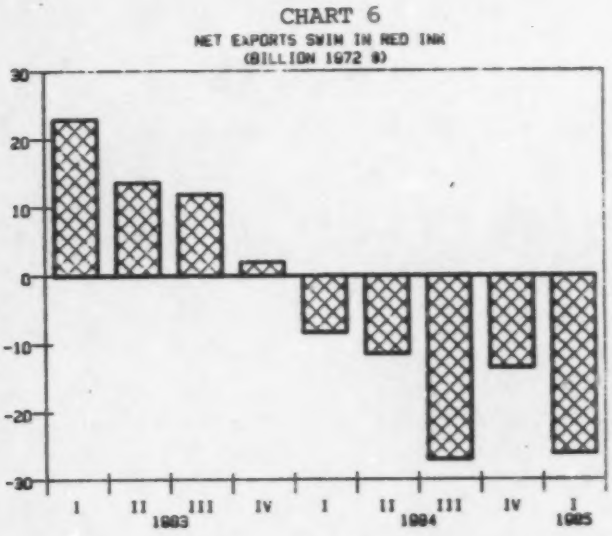
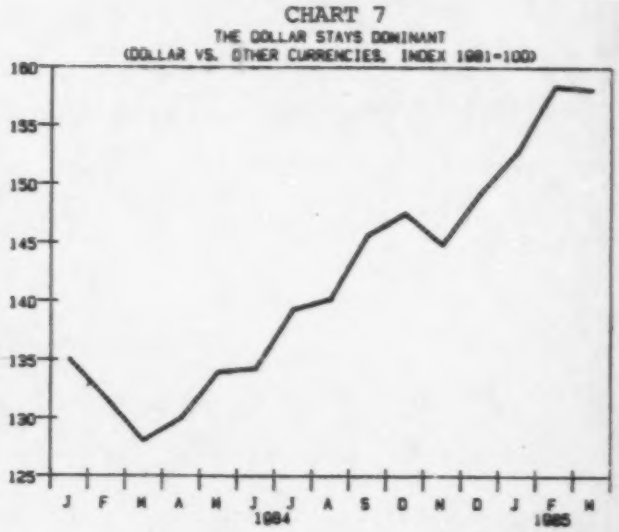


CHART 7



Yet despite the deterioration in trade last year, economic growth was heady as everything else continued to rebound buoyantly from the steep 1981-82 recession. This year the story is different: The non-trade sectors will not be able to grow as strongly as last year when there was still a lot of catching up on spending that got curtailed during the recession. Hence the 1985 economy will be much more subject to the vicissitudes of foreign trade, which means an increased chance of recession.

And although the dollar is expected to fall further this year, it will hardly be enough to get the trade account back in the black. In fact, net exports are forecast to go deeper into the red this year.

To boost U.S. exports and quell imports by 1986, the dollar must fall significantly in 1985. But for that to happen, Congress and the White House must start making more progress on reducing the federal budget deficit than they have made to date. In addition, U.S. manufacturers will have to keep up their capital investment in productivity-boosting equipment and structures. The past two years have shown that manufacturers will invest heavily when they have the internal sources. If the economy sinks under the weight of the trade deficit, however, capital spending could be curtailed, making the trade problem more insoluble.

Summary

First-quarter economic growth of only 1.3% may raise grave doubts about business prospects in 1985. There are enough quirks in the data, however, to put off worrying too much until the second-quarter statistics come in. Specifically, it's probable that government spending, capital investment, and residential construction will all look better in the spring.

Meanwhile, consumers are in good shape; it's just that much of their spending is going for foreign products, which reduces GNP. If the foreign trade account continues to deteriorate rapidly, then chances of a recession late this year or in 1986 become great. True, trade deterioration was great last year; but other sectors were so buoyant that they far outweighed the "balance" of trade. This year, in contrast, the business expansion is more mature, meaning that most economic sectors have less potential for growth. Hence the economy is much more sensitive to developments in foreign trade.

The basic cure for trade is a dollar decline, which depends on an interest rate decline, which depends on a declining federal budget deficit. But given action to date in Washington, hopes for a significant yet gradual dollar drop are not high. This prognosis points to continued severe trade problems, which ironically could lead to a recession that would in turn cause the dollar to tumble as foreign investors lost confidence in the U.S. economy.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1985				1986			Years		
	I	II	III	IV	I	II	III	83	84	85
National Product Accounts										
Gross National Product	3,820	3,878	3,929	3,985	4,039	4,096	4,162	3,305	3,663	3,903
Consumer Spending	2,443	2,485	2,522	2,562	2,604	2,644	2,687	2,156	2,342	2,503
Durables	333	340	344	349	353	357	362	280	319	341
Nondurables	878	889	899	910	921	932	943	802	857	894
Services	1,232	1,256	1,280	1,304	1,330	1,356	1,383	1,074	1,166	1,268
Nonresidential Fixed Investment	456	463	469	477	485	493	503	353	426	466
Structures	164	168	169	171	173	175	178	130	150	168
Equipment	291	296	300	306	312	318	325	223	275	298
Inventory Change	47	36	34	33	29	25	22	-13	58	37
Residential Investment	151	154	161	161	161	163	165	129	150	157
Federal Government	320	329	334	342	347	352	357	270	295	331
Defense	235	242	246	254	259	265	270	201	222	244
Nondefense	86	87	88	88	88	87	87	69	74	87
State & Local Government	473	482	491	500	509	517	526	416	452	486
Net Exports	-73	-75	-88	-95	-100	-102	-103	-8	-64	-83
Real GNP (1972 Dollars)	1,668	1,681	1,692	1,702	1,710	1,719	1,730	1,535	1,639	1,686
(% change, annual rate)	1.3	3.2	2.7	2.3	1.9	2.0	2.6	3.7	6.8	2.8
Implicit Price Deflator	2.290	2.307	2.321	2.341	2.362	2.383	2.406	2.153	2.234	2.315
(% change, annual rate)	5.3	2.9	2.6	3.4	3.6	3.7	3.9	3.8	3.8	3.6
Key Economic Indicators										
Housing Starts (million units)	1.792	1.830	1.815	1.809	1.766	1.750	1.771	1.703	1.766	1.811
Retail Auto Sales (million units)	10.8	10.7	10.8	10.8	10.5	10.5	10.6	9.2	10.4	10.8
Industrial Production (Index, 1967=100)	165.2	166.5	168.2	169.4	170.8	172.1	172.8	147.6	163.3	167.3
Civilian Unemployment Rate	7.3	7.4	7.4	7.5	7.6	7.7	7.8	9.6	7.5	7.4
Consumer Price Index (% Change, Annual Rate)	3.3	3.7	3.5	3.8	4.0	4.1	4.2	3.2	4.3	3.5
Personal Income (billion $)	3,142	3,185	3,231	3,287	3,334	3,390	3,442	2,744	3,012	3,211
3-Month Treasury Bill Rate (%)	8.2	7.9	8.1	8.6	8.6	8.5	8.2	8.6	9.5	8.2
Corporate Bond Yield (%)	12.3	12.1	11.8	11.8	11.8	11.7	11.5	12.0	12.7	12.0
Personal Income ($ Billions, SAAR)	3,142	3,185	3,231	3,287	3,334	3,390	3,442	2,744	3,012	3,211

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August, 1985

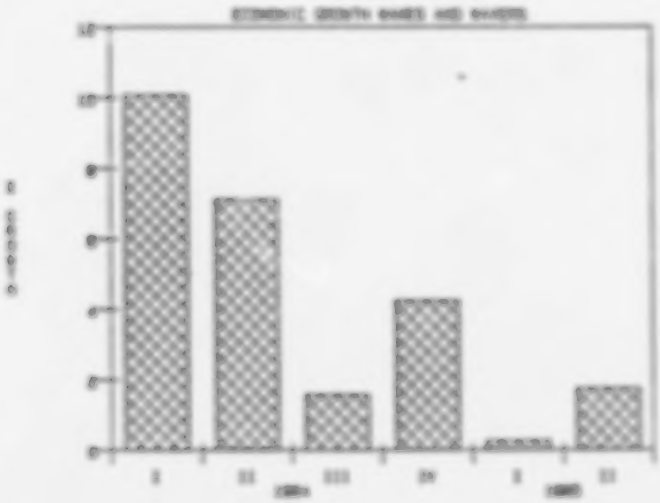
BUSINESS OUTLOOK, SHORT-TERM

The economy is waffling.

In the past four quarters, growth has yo-yoed up and down (Chart 1); but overall, economic activity since the spring of 1984 has advanced only 1.9%. Disconcerting to say the least. In contrast to this sluggishness, forecasters six months ago had been looking for more than 3% growth in 1985.

The big reason for slow growth has been surging imports. The big reason for surging imports has been the mighty dollar. And the big reason for the mighty dollar has been high interest rates that have attracted a flood of foreign investment (i.e., a flood of demand for dollars).

CHART 1



Of late, however, some of the above forces have been reversed. A weakening economy and sustained disinflation have pulled interest rates down. U.S. interest rates are now lower than in some other major industrial countries. Hence the dollar, at long last, is headed down.

So while much economic news has been downbeat in the past year, key causes of the economy's querulousness may in part be coming undone.

But not undone enough to spur a renewed business boom. While interest rates have dropped dramatically since last year, they remain high by historic standards; and they may still be high enough to keep the dollar well above levels that would make U.S. manufacturers happy. What's more, even a falling dollar won't really be of much help until next year. The forecast for the next four quarters, therefore, calls for plodding growth. If any big move, either up or down, does occur, it will probably be kicked off in Washington by federal budget action. Or inaction.

The Dollar Decline: 1985's Biggest Blessing

If you closed your eyes and pretended the rest of the world didn't exist in the past four quarters, the U.S. economy would have looked better than it did in reality. Excluding imports and exports, the economy grew 3.3% from the second quarter of 1984 to the second quarter of 1985. Including foreign trade, growth was only 1.9%, thanks to the demon dollar.

Exorcism of the dollar required a fall in interest rates and a weakening economy. We have gotten both, to the point where interest rates in several other industrial countries are now high relative to the U.S. (Table 1); this switch around in rates should siphon demand away from the U.S. currency.

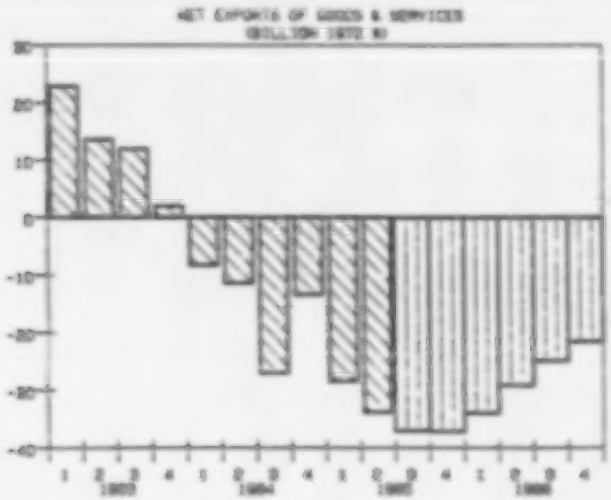
Table 1. Prime Interest Rates in Major Industrial Countries

	Recent	Six Months Ago	Year Ago
Britain	12.0%	9.5%	12.0%
France	11.3	12.0	12.3
Canada	10.5	11.3	13.5
U.S.	9.5	10.5	13.0
Germany	6.0	6.0	6.0
Japan	5.5	5.5	5.5
Switzerland	5.5	5.5	5.5

Additionally, some of the supreme confidence foreign investors have shown in the U.S. in recent years may be shaken: The U.S. has not grown at a robust pace since the spring of 1984; the U.S. manufacturing sector is patently in difficulty; billions of dollars keep pouring out of the gaping trade deficit; and more recently, growth in employment has slowed. The good news emanating from this darker side of the economy is that foreign investors may look twice before cavalierly sinking more funds into the U.S., thus helping the dollar to ease further.

The bad news from the dollar front is that imports and exports do not react instantaneously to movements in exchange rates. Contracts have been signed and plans made based on previous rates. Hence, a boost to the U.S. economy from foreign trade is not foreseen until 1986 (Chart 2). Nonetheless, downward pressure on the dollar does suggest that the massive trade gap, after adjusting for inflation, will probably not worsen as fast as in recent quarters; thus trade will not be hurting the economy to the extent that it did in the past year.

CHART 2



Back on the negative side, bear in mind the mountaintop from which the dollar began its recent descent. As of mid-1985, the dollar compared to currencies of other major countries was 7% greater than its average 1984 value, and nearly 70% greater than in 1980, when the merchandise trade gap was already large (Table 2).

Table 2. The Dollar is Still Strong

	Trade-Weighted Value of U.S. Dollar (Index, 1971=100)	U.S. Merchandise Trade Deficit (Billion $)
1980	87.4	24.3
1981	103.3	27.5
1982	116.5	31.6
1983	125.3	57.5
1984	138.3	108.0
mid-1985	147.7	120.0 (annualized)

Housing Should Heat Up

Besides foreign trade, another deterrent to growth in the past year has been housing. As mortgage rates rose in 1984, housing starts sagged. But with mortgage rates easing in 1985 the market naturally improved, as shown in Table 3.

Table 3. Housing Improves as Mortgage Rates Fall

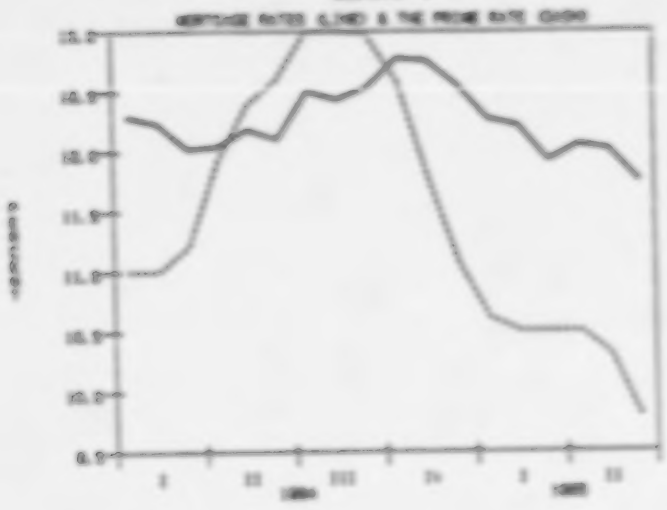
		Mortgage Rate (%)	---Thousands of Units (SAAR)---- Existing Home Sales	New Home Sales	Housing Starts
1984	I	12.2	2917	683	1947
	II	12.1	2973	633	1858
	III	12.5	2763	614	1663
	IV	12.7	2813	617	1598
1985	I	12.1	2970	669	1795
	II	11.9	3050	676	1770

SAAR--Seasonally adjusted annual rate

What's more, since mortgage rates tend to lag behind movements in short-term rates (Chart 3), costs of financing a new home should continue down. Hence the forecast is relatively bullish for housing starts, which could conceivably approach the magic mark of two million at an annual rate in some quarter this year or next.

Behind the pleasant facade of declining mortgage rates, however, lurk some less positive conditions. One is tax reform. If the President's tax program is adopted, homeowners would lose the right to deduct property taxes from income for federal tax purposes, effectively raising the after-tax cost of owning a house. Also, lower marginal tax rates, while a boon to disposable income, at the same time diminish the value of mortgage interest deductions.

CHART 3



All told, the National Association of Realtors figures the Reagan tax package would knock home values down as much as 10%. That reduction might stimulate some home sales; but it would certainly cast a pall over the market where most Americans have most of their wealth. If people felt their biggest asset were suddenly undercut, they might decide not to sell at the new fair market value. Home builders, meanwhile, could decide that under the new tax regime the only way to sell an average new house would be to cut the price below acceptable levels; as a result, they might focus on the high end of the market where profit margins are fatter, and thereby reduce the total number of houses built.

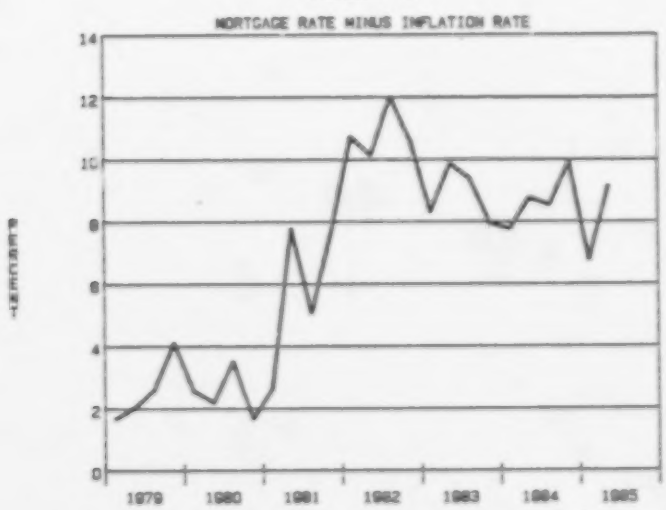
Tax reform would also take a bite out of multi-unit residential construction. A key clause here: The stretchout of depreciation lifetimes on income properties from 18 to 28 years. Which means that in the early years of an investment depreciation charges would be less than under current law, hence taxes higher. Other proposed changes in tax laws would also hurt multi-unit housing: The limitation of deductions for investors to $5,000 plus investment income, and the "at-risk" rule that would limit tax deductions to the amount

of the total investment for which an individual is personally liable. In 1985, on the other hand, construction could quicken if developers accelerate projects in hopes of getting grandfathered.

Another damper on the housing outlook is that while mortgage rates have hit their lowest point in five years, they are still a lot higher than the inflation rate (Chart 4). Since the inflation rate is a rough indicator of how fast people's income will rise, the inflation-adjusted mortgage rate is a measure of how hard or easy it is to finance a house purchase. Note, too, that as adjustable-rate mortgages became popular in the past couple of years, the rate of mortgage delinquencies and defaults rose. That despite the fall in mortgage rates. It could be that rates have not fallen enough in recent years given the modest growth in people's ability to pay. Another worry is the slowdown in employment growth, which implies slower income growth.

In combination, these negative forces of late seem to have overpowered the positive ones: In May, housing starts plunged compared to April; and in June, starts improved only slightly. In consequence, starts for the whole second quarter came in lower than in the first quarter. Nonetheless, the second quarter performance--1.77 million starts at an annual rate--is not bad by historical standards, given the level of mortgage rates.

CHART 4

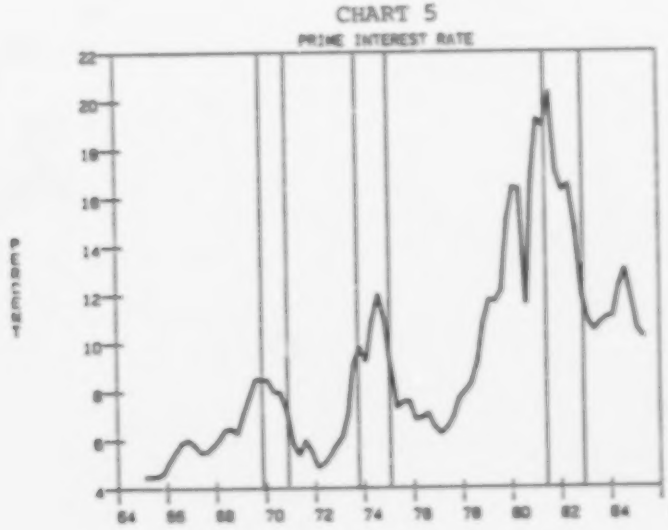


Neither Boom Nor Bust

Irrespective of these negatives in the housing outlook, residential construction prospects are good. So with housing headed up, and the dollar and interest rates down, it's hard to foresee an economic slump in the near future, as some analysts have been projecting and as the weak economy may suggest.

Rather, the economy has already experienced a slump as a result of high interest rates. Except it wasn't a full-blown recession, but a "growth recession" (where the economy grows sluggishly). If this assessment is correct, it would explain why interest rates have plummeted this year--namely, the weak economy depressed demand for funds (as the Federal Reserve pumped up the supply of credit). For as the record shows (Chart 5), substantial declines in interest rates only occur during recessions or in the immediate aftermath of recessions. (In Chart 5, the 19769-70,1973-75, and 1981-82 recessions are designated by vertical lines.) The corollary is that lower rates pave the way to renewed growth, usually spearheaded by housing construction.

CHART 5



The current period is not quite comparable, however, to periods following bona fide recessions. True, growth has been slow of late, but the economy did not go through the wringer as in 1974-75 or 1981-82. Too, while the prime rate is down three and a half percentage points from a year ago, it is still higher than it was when sharp economic growth was ignited in early 1971 (after the 1969-70 recession) or the spring of 1975 (after the 1973-75 recession). In inflation-adjusted terms, moreover, the prime today is much higher than in 1971 or 1975, though lower than in early 1983 when the economy started to catch fire (Table 4).

Table 4. The Prime Rate at the Start of Economic Upswings vs. Today

	Prime Rate (%)	Real Prime (%)*
1971: I	5.9	-0.1
II	6.0	2.5
1975: II	7.3	2.2
III	7.6	0.2
1983: I	10.9	5.8
II	10.5	7.9
1985: II	9.5	6.7

*Prime rate minus annualized percent change in the gross national product implicit price deflator.

Another difference between now and some earlier periods when interest rate declines sparked strong growth is that the dollar is much stronger; hence the trade balance and U.S. manufacturing is in worse shape.

The point here is that while the big interest rate drop of 1985 is great for the economy, it doesn't presage a strong pickup in business as in past periods of large interest rate declines. Yet while a boom is not visible in the crystal ball, neither is a bust: Lower interest rates will prevent a recession, a point supported by the second-quarter gross national product (GNP) figures.

Hope Arises from the Second-Quarter Numbers

On the face of it, the second quarter was abysmal, with real GNP growing at only a 1.7% annualized rate. But an inventory rundown accounted for most of the weakness. Final demand, which excludes inventories, jumped at robust 5.1% annual rate.

Of particular note, both consumer spending and business capital investment came in very strong. For the consumer, the second quarter continued a long-standing strong performance. For business investment, however, the second quarter marked a welcome turnaround from a first-quarter inflation-adjusted decline.

During the rest of the year, both consumer and capital investment are expected to grow, but at a slower rate than in the second quarter. A slowdown in employment growth and a heavy debt burden should dampen consumer enthusiasm, while the weak economy and declining profits should cut into capital spending budgets.

Business confidence could also suffer if Congress continues to logjam instead of logroll on the federal budget. Lack of compromise on spending cuts could lead to an upturn in interest rates, which would jeopardize the chances of further economic growth in 1986. A surprise agreement, on the other hand, could bolster confidence in financial markets, setting the stage for another decline in interest rates and decent economic advance next year.

Summary

In the past year the U.S. economy has taken the low-growth road, after traveling headily on the high-growth road since early 1983. One fear is that low growth will lead to recession. Recession, however, is not in the

forecast, because lower interest rates induced by the weakening economy should buoy business into 1986.

At the same time, no boom is foreseen either. While interest rates are down a lot from last year, they are still high by historical standards; and they remain particularly high compared to inflation.

The next four quarters, therefore, look something like an economic purgatory. It's hardly the best of all possible worlds; but neither is it the worst.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1985			1986				Years		
	II	III	IV	I	II	III	IV	84	85	86
National Product Accounts										
Gross National Product	3,854	3,912	3,964	4,018	4,076	4,139	4,217	3,663	3,885	4,112
Consumer Spending	2,496	2,532	2,564	2,601	2,638	2,679	2,723	2,342	2,510	2,661
Durables	341	345	345	348	350	353	359	319	341	352
Nondurables	895	900	908	917	925	935	946	857	895	931
Services	1,261	1,287	1,311	1,337	1,363	1,390	1,419	1,166	1,273	1,377
Nonresidential Fixed Investment	467	474	476	483	489	500	514	426	467	497
Structures	172	176	176	177	178	180	184	150	171	179
Equipment	295	299	300	307	312	321	330	275	296	317
Inventory Change	13	25	34	28	25	21	24	58	28	24
Residential Investment	155	160	166	169	170	172	175	150	158	171
Federal Government	325	332	336	339	342	344	346	295	328	343
Defense	241	244	250	253	255	258	261	222	242	257
Nondefense	84	87	86	86	86	85	84	74	86	86
State & Local Government	485	494	503	512	521	529	538	452	488	525
Net Exports	-91	-109	-119	-118	-114	-110	-108	-64	-99	-113
Real GNP (1972 Dollars)	1,671	1,685	1,694	1,703	1,713	1,724	1,739	1,639	1,678	1,720
(% change, annual rate)	1.7	3.5	2.1	2.2	2.3	2.6	3.7	6.8	2.4	2.5
Implicit Price Deflator	2.307	2.322	2.341	2.360	2.380	2.401	2.424	2.234	2.315	2.391
(% change, annual rate)	2.8	2.6	3.3	3.3	3.5	3.6	3.9	3.8	3.6	3.3
Key Economic Indicators										
Housing Starts (million units)	1.770	1.931	1.923	1.863	1.860	1.875	1.879	1.766	1.855	1.869
Retail Auto Sales (million units)	10.9	10.9	10.7	10.6	10.5	10.5	10.6	10.4	10.8	10.5
Industrial Production (Index, 1967=100)	166.4	167.3	168.3	169.3	170.3	171.6	173.6	163.3	166.9	171.2
Civilian Unemployment Rate	7.3	7.3	7.4	7.4	7.5	7.5	7.6	7.5	7.3	7.5
Consumer Price Index (% Change, Annual Rate)	4.2	2.8	3.7	3.7	3.9	4.3	4.4	4.3	3.5	3.8
Personal Income (billion $)	3,182	3,228	3,275	3,325	3,378	3,434	3,494	3,012	3,207	3,408
3-Month Treasury Bill Rate (%)	7.5	7.2	7.7	7.6	7.3	7.2	7.3	9.5	7.6	7.4
Corporate Bond Yield (%)	11.6	10.9	11.0	10.8	10.6	10.5	10.5	12.7	11.5	10.6
Personal Income ($ Billions, SAAR)	3,182	3,228	3,275	3,325	3,378	3,434	3,494	3,012	3,207	3,408